



# Regulation Impact Statement

## Conglomerate supervision (Level 3) framework

(OBPR ID: 2013/15337)

### Background

This Regulation Impact Statement (RIS) addresses the Australian Prudential Regulation Authority's (APRA's) proposal to introduce a conglomerate supervision framework (Level 3 framework) that would apply to APRA-defined conglomerate groups.

APRA's mandate is to ensure the safety and soundness of prudentially regulated financial institutions so that they can in all reasonable circumstances meet their financial promises to depositors, policyholders and superannuation fund members within a stable, efficient and competitive financial system. APRA's mandate is also to promote financial system stability in Australia. APRA carries out this mandate through a multi-layered prudential framework that encompasses licensing and supervision of the institutions it regulates (APRA-regulated institutions).

APRA is empowered to issue legally binding prudential standards that set out specific requirements with which APRA-regulated institutions — authorised deposit-taking institutions (ADIs), general insurers and life companies (collectively, insurers) and registrable superannuation entity licensees (RSE licensees) — must comply<sup>1</sup>. APRA also publishes prudential practice guides (PPGs), which clarify APRA's expectations with regard to prudential matters. PPGs frequently discuss legal requirements from legislation, regulations or APRA's prudential standards, but do not themselves create enforceable requirements.

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<sup>1</sup> APRA's prudential standard-making powers are found in the *Banking Act 1959* (the Banking Act), the *Insurance Act 1973* (the Insurance Act), the *Life Insurance Act 1995* and the *Superannuation Industry (Supervision) Act 1993* (the SIS Act). These apply to ADIs, general insurers, life companies and RSE licences, respectively.

APRA currently supervises ADIs, insurers and RSE licensees on a ‘Level 1’ stand-alone basis. It also supervises a group of related ADIs or a group of related general insurers on a ‘Level 2’ basis.<sup>2</sup>

APRA now proposes to implement a conglomerate supervision framework that will enable supervision to be undertaken on a whole-of-group ‘Level 3’ basis that will largely be based on its current Level 1 and Level 2 prudential requirements.

## Problem

Since its establishment APRA has been conscious of the need to understand and assess the financial and operational aspects of conglomerate groups, as well as the individual APRA-regulated institutions within them. APRA is already supervising banking and general insurance groups on a group basis. This supervision is, however, strictly limited to the banking or general insurance sub-group and ignores group members active in other APRA-regulated or non-APRA-regulated industries. History has demonstrated that the failure of one institution (regulated or not) within a conglomerate group may damage or even cause the failure of related institutions. A salient example is the 2008 near-collapse of the large US insurance group American International Group (AIG) which suffered significant losses and acute liquidity problems stemming from the operations of an unregulated overseas subsidiary. AIG was ultimately bailed out by the United States Government to protect policyholders and prevent a systemic financial crisis. AIG Financial Products, the subsidiary that brought down AIG group, is highlighted in the following example:

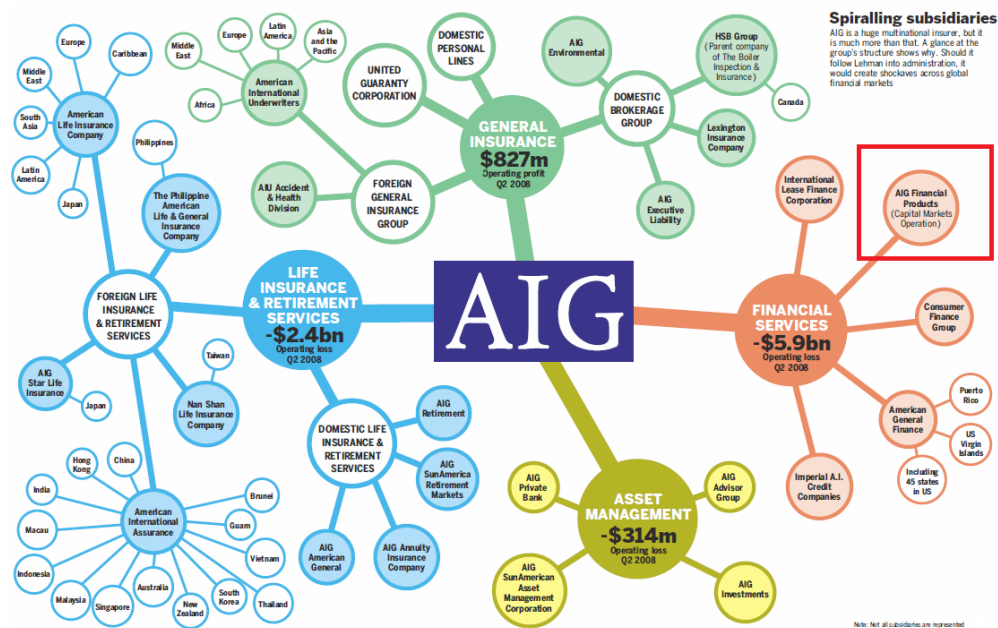


Figure 1: A diagram of AIG group structure with the red box highlighting AIG Financial Products. Source: Financial Times 17 September 2008.

<sup>2</sup> There is currently no group regime for life companies or RSE licensees. Group members not active in the Level 2 group’s industry (banking or general insurance, as relevant) are deconsolidated for Level 2 purposes and are not captured by APRA’s Level 2 prudential requirements.

Another example is the failure of a number of European bancassurance groups, notably Fortis and Dexia. Many other conglomerate groups did survive but ultimately required taxpayer-funded bailouts.

Compared to other developed countries, Australia's financial system weathered the global financial crisis well. This, however, does not mean that the overseas failures and near-failures of conglomerate groups hold no lessons for Australia. APRA considers that the failure of a conglomerate group must be avoided as the potential large-scale economic disruption and financial costs could severely impact the Australian economy.

Although membership of a conglomerate group may provide benefits to APRA-regulated institutions, group membership may also increase and change the risks they face. The more material a group's activities outside its primary industry, the greater the risk that an industry-focused supervisory regime will not appropriately detect or respond to risks associated with these activities. These Board, management, and/or supervisory 'blind spots' may result in risks building up without adequate control or remediation. Membership of a conglomerate group can create:

- *financial contagion risks*, stemming from transactions between group members or transactions involving both group members and third parties, such as intra-group investments and loans, insurance and reinsurance, guarantees, letters of comfort and cross-default provisions. Non-APRA-regulated institutions might be undercapitalised or group treasury arrangements may oblige, implicitly or explicitly, APRA-regulated institutions to bail out other members of the group, placing significant financial reliance on APRA-regulated institutions;
- *reputation risks*, where adverse publicity about a group member, whether accurate or not, may cause a loss of confidence in the integrity of an APRA-regulated institution within the group. Such damage may threaten its relationship with customers and other stakeholders. A loss of trust and confidence on the part of investors in the group may also impair an APRA-regulated institution's access to funding. Reputation risk to APRA-regulated institutions is increased with group practices such as common group branding, common funding and common management. There is also a potential for systemic reputation risk, where loss of confidence in one financial conglomerate group may undermine confidence in other financial conglomerates;
- *moral hazard risks*, which may arise where a group member engages in excessive risk-taking activities on the assumption that, if a problem arises, another group member will come to its assistance. Investors may transact with group members on more favourable terms due to the assumption that the conglomerate group would bail out the group member. Any group member in financial stress that seeks support from a holding company or other group members may induce riskier behaviour than would otherwise occur;
- *operational risks*, associated with internal processes, people and systems or external events that originate in one part of the group and may adversely affect other parts of the group, notably APRA-regulated institutions. This risk can be driven by the size and complexity of the group; and

- *governance and strategic risks*, which may arise from the legal structure, managerial structure or diversity of the group. Governance arrangements typically become more complicated where there are common directors and management across group members. This can threaten the ability of individual APRA-regulated institutions in the group to make strategic decisions and business judgments in the best interests of the regulated institution, with due consideration of the interests of depositors, policyholders and superannuation members.

These risks also reflect the way in which contagion risks within a conglomerate group can increase the risks APRA-regulated institutions face. Such risks already affect APRA-regulated institutions to varying degrees and are addressed to some extent through the prudential requirements of APRA's Level 1 and Level 2 supervision frameworks. However, these frameworks largely focus on the individual APRA-regulated institutions or sub-groupings of similar APRA-regulated institutions without full consideration of the group in which the institution(s) may operate and the implications of group membership. The interaction of these risks within a group context requires more effective group-wide supervision beyond the existing frameworks.

Contagion risk is increased by arrangements that can compromise the independence of members of the group, whether these are based on explicit arrangements or from fear of the reputational consequences of not supporting other members in the group. Members of a group may, for example, have debt and equity cross-holdings with other members in the group. These cross-holdings limit the financial strength of group members, as the default of one institution immediately impacts the financial strength of other members. Cross-holdings create significant financial interdependence, compromising the risk-based decision-making of individual members.

APRA considers that a narrow, stand-alone view of regulated institutions is insufficient to obtain a full picture of the financial risks to which depositors, policyholders and superannuation members may be exposed. The existence of financial and commercial group members which are undercapitalised compared with peers that are not members of conglomerate groups distorts competition and increases the risks in the Australian financial system. Undercapitalisation can occur by structuring a conglomerate group to engage in undetected capital upgrading, where debt is down-streamed into an APRA-regulated subsidiary as equity, or gearing, where a group's equity is included in more than one APRA-regulated institution's available capital. Capital upgrading and gearing can significantly misrepresent the financial strength of APRA-regulated institutions in a conglomerate group. This exposes depositors, policyholders and superannuation members to additional risk and provides a competitive advantage over APRA-regulated institutions that are not members of a conglomerate group. Capital upgrading and gearing are difficult to detect by financial markets and APRA under the existing supervision framework, as these are internal transactions about which the market and APRA have limited information. APRA's ability to assess the true financial strength of APRA-regulated group members would be significantly enhanced by a consolidated view of the group's risk profile and these internal transactions.

A narrow, stand-alone view of regulated institutions could further lead to undercapitalised commercial (non-financial) operations being subsidised through

group membership, distorting competition by being able to operate with less capital than peers that are not members of conglomerate groups. Clients of a groups' commercial operations are likely to accept the risks associated with the commercial operations' undercapitalisation as they assume that the operations are implicitly backed by prudentially regulated institutions, which may use capital holdings to provide financial support to related institutions of the group for reputational reasons.

It could be argued that diversification is a benefit of conglomerate group membership: by performing activities in various industries, losses in one industry can be offset by profits in another. APRA does not dispute the potential for diversification benefits to arise in normal financial situations. However, in a financial crisis the diversification benefits can disappear, and concentration and contagion risks can manifest. One example of a conglomerate group affected by the disappearance of diversification benefits is the ING Group. The group's banking and insurance operations were separate subsidiaries of a non-operating holding company which was 10 per cent geared. The group argued that this gearing reflected diversification benefits between the banking and insurance businesses. During the global financial crisis, the group required a €10 billion bailout from the Dutch Government, of which €3 billion was provided to the holding company to reduce its debt/equity ratio. This was a consequence of the significantly reduced diversification benefits in a time of crisis. These taxpayer funds did not support depositors or policyholders but instead were deemed necessary to prevent a loss of market confidence and potential contagion. APRA considers that diversification is driven by assumptions. These assumptions can quickly transform and even reverse following a significant deterioration of economic conditions.

Overall, the likely consequences of inadequate supervision of conglomerate groups include: increased risks to the Australian financial system, increased risks to depositors, policyholders and superannuation members, and increased risk of Government bailouts. There is currently a regulatory gap in relation to this issue, as APRA's existing Level 1 and Level 2 supervision frameworks do not explicitly address these risks.

APRA considers that the complexity of conglomerate groups limits the potential for private or commercial incentives to reduce the risks to which conglomerate groups are exposed:

- shareholders have an asymmetric incentive for risk-taking, through limited downside losses and potentially unlimited upside gains;
- while credit ratings issued by rating agencies provide an incentive for groups to ensure adequate capitalisation, these ratings are limited to assessing the risk to a group's shareholders and debt holders, rather than all stakeholders, including customers, suppliers and the broader community. Further, the credit ratings of certain conglomerate groups and group members include an uplift due to assumed Government support; the incentive to ensure adequate capitalisation is therefore at least partially transferred from the group to the Government;
- clients of groups' commercial operations are willing to accept the risks associated with the commercial operations' undercapitalisation as they assume that the operations are implicitly backed by the group, and presumably also

because they assume that the prudential regulator (i.e., APRA) would ensure that the group as a whole is appropriately capitalised;

- depositors and general insurance policyholders are protected by Financial Claims Schemes and depend on APRA to fulfil its statutory obligations to protect their interests; and
- significant private losses suffered by a conglomerate group could adversely affect public confidence in other financial institutions and in the Australian financial system as a whole.

For the above reasons, APRA considers that conglomerate group supervision is both necessary and warranted.

The necessity of adequate conglomerate group supervision is also borne out by APRA's international peers. In response to the lessons learned from the global financial crisis, the Joint Forum released in September 2012 updated *Principles for the supervision of financial conglomerates*<sup>3</sup> (2012 Principles). The Joint Forum was established in 1996 under the aegis of the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions and the International Association of Insurance Supervisors (IAIS) to deal with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates. The Joint Forum comprises an equal number of senior bank, insurance and securities supervisors representing each supervisory constituency. APRA is a member of the Joint Forum through the IAIS, and is also a member of the BCBS.

The Joint Forum's objective in preparing the 2012 Principles is to provide national authorities, standard setters, and supervisors with a set of internationally agreed principles that support consistent and effective supervision of financial conglomerates and in particular those financial conglomerates active across borders. These principles are the most important international reference work in this space for prudential regulators. The Joint Forum's aim is to focus on closing regulatory gaps, eliminating supervisory 'blind spots', and ensuring effective supervision of risks arising from unregulated financial activities and institutions. The 2012 Principles are to be applied in a proportionate manner to the risks posed and should at least be applied to large internationally active financial conglomerates. The document details 29 principles and associated implementation criteria in relation to the appropriate supervision of conglomerate groups.

APRA has dealt with supervisory 'blind spots' in relation to conglomerate groups through various *ad hoc* supervisory arrangements. In the case of some groups, this is limited to occasional information requests whereas others have a range of additional requirements regarding capital adequacy, risk management, risk exposures and group-wide governance arrangements. These *ad hoc* arrangements are, however, inefficient in terms of cost and outcome when compared with a consistent framework. Without a group-wide supervision framework, it is challenging for APRA to appreciate how individual risks within a group interact, limiting the effectiveness of APRA's supervision of these groups.

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<sup>3</sup> <http://www.bis.org/press/p120924.htm>.

APRA intends that the Level 3 framework will initially be applied to eight conglomerate groups. These conglomerate groups are among the largest financial service providers in Australia and include material APRA-regulated institutions as well as multiple non-APRA-regulated businesses, some of which operate across numerous jurisdictions. These non-APRA-regulated businesses include fund managers, administrators, custodians, and commercial (non-financial) operations. In aggregate, the eight Level 3 groups represent approximately 73 per cent of the \$5.5 trillion of assets under APRA supervision. Based on current information, APRA believes the likelihood of other conglomerate groups being designated Level 3 groups within a 10 year time horizon is low. However, should unexpected developments result in a group being designated a Level 3 group by APRA, such a group would be given an appropriate amount of transitional time to comply with the Level 3 framework.

## **Objectives**

APRA's primary objective for this proposal is to ensure that its prudential supervision adequately captures the risks to which beneficiaries of APRA-regulated institutions within a conglomerate group are exposed.

## **Options and impact analysis**

APRA has identified three options to address identified deficiencies in the prudential framework for Australian conglomerate supervision:

- Option 1 - status quo: maintain APRA's existing prudential framework, with limited oversight of the risks posed by non-APRA-regulated members of a group;
- Option 2 – partial implementation of a Level 3 framework that includes only group risk management and governance requirements, which would be based on those applying at Level 1 and (where relevant) Level 2; or
- Option 3 – full implementation of a Level 3 framework that would include the risk management and governance requirements from Option 2 and add further requirements relating to risk exposures and capital adequacy. The capital adequacy requirements would be based on existing Level 1 and Level 2 requirements, with some additional requirements for materially risky non-APRA-regulated activities.

### **Option 1 — status quo**

Under this option, the existing 'blind spots' to risks arising from group membership would remain unchanged. This would mean that groups are not required to understand the material risks posed by non-APRA-regulated institutions to APRA-regulated institutions in the same group.

### ***Benefits***

The primary benefit of this option is that it would impose no new requirements on conglomerate groups. This would introduce no immediate costs to those conglomerate

groups that have inadequate oversight and management of risk via governance, risk management, risk exposures and capital adequacy arrangements. Maintaining the status quo would provide the parent entity of a conglomerate group with the flexibility to determine whether it needs oversight of the risks posed by non-APRA-regulated institutions in the group, and to choose to delay or not to implement minimum standards across the group.

### *Costs*

Option 1 would leave in place potential ‘blind spots’ relating to a conglomerate group’s financial, reputation, moral hazard, operational, and governance and strategic risks. This would expose depositors, policyholders and superannuation members, financial markets and the Australian taxpayer to additional risks; these costs can only be partly addressed through APRA’s current *ad hoc* supervisory arrangements. It would deny to the Australian financial system the benefits from the lessons learned during the global financial crisis about financial conglomerate risks.

APRA would continue to have ‘*ad hoc*’ insight into whether regulatory ‘blind spots’ are also Board ‘blind spots’. Conglomerate groups would be allowed to choose how material risks from non-APRA-regulated institutions should be managed. This could result in activities that pose material risks to APRA-regulated institutions not being subject to minimum standards that would apply if the risk was held by regulated institutions in the group. It would also remain the case that conglomerate groups could more readily create capital artificially through intra-group transactions, and APRA’s ability to detect and respond to such arrangements is limited.

The global financial crisis highlighted the considerable social and economic consequences when the Boards of parent entities and their regulators do not adequately oversee and understand the material risks to these groups.

As outlined above, the eight Australian conglomerate groups intended to be subject to the Level 3 framework control a large proportion of the assets held by APRA-supervised institutions. Maintaining the status quo means that these groups would be slightly less prudentially safe, and the Australian financial system would also be slightly less safe, than would be the case should APRA implement a Level 3 framework.

### **Option 2 — partial implementation of a Level 3 framework**

Under options 2 and 3, APRA would establish a Level 3 supervision framework for conglomerate Level 3 groups. A ‘Level 3 group’ is a group that performs material activities across more than one APRA-regulated industry and/or in one or more non-APRA-regulated industries. The Level 3 group would comprise the APRA-regulated parent institution and its subsidiaries. The Level 3 framework would be applied to the parent APRA-regulated institution in a conglomerate group (the ‘Level 3 Head’), which in turn must ensure that all material risks to depositors, policyholders and superannuation members, including from group membership, are captured by the Head’s policies. The following diagram illustrates the coverage of the proposed Level 3 framework:



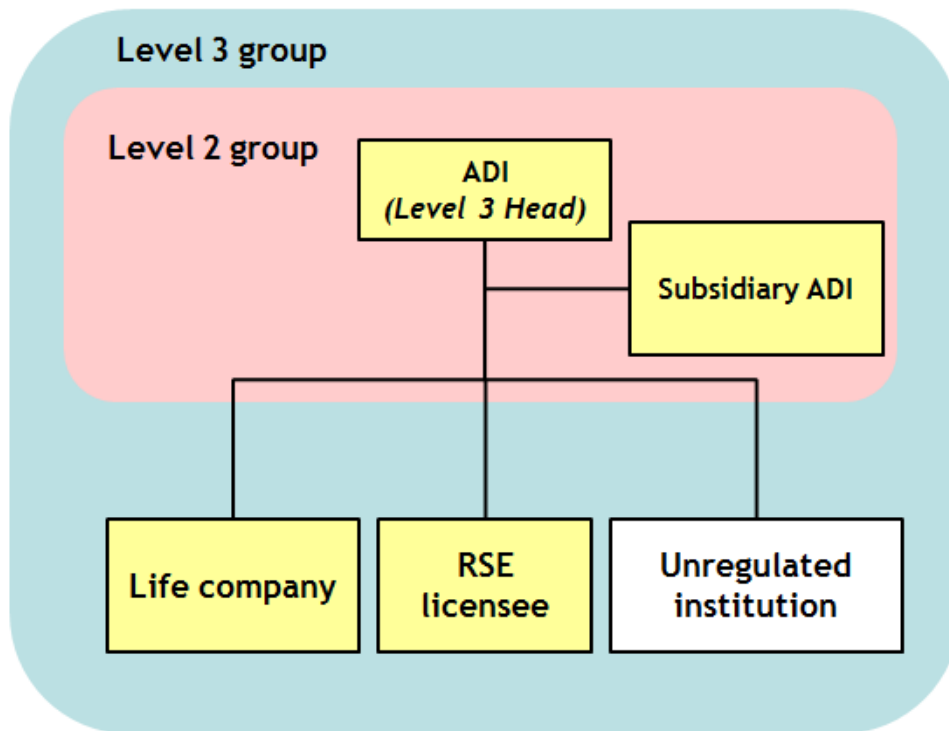
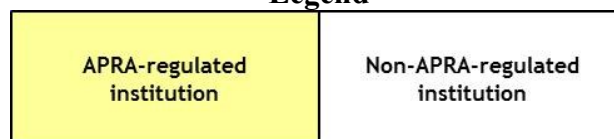


Figure 2: An example of a Level 3 group that includes a Level 2 group.

### Legend



The legend for Figure 2 indicating APRA-regulated and non-APRA-regulated institutions.

In Figure 2 above, the ADI, life company and RSE licensee are institutions that APRA currently supervises on a Level 1 (stand-alone) basis only. The Level 2 (industry) group is made up of the parent ADI and the subsidiary ADI. For the purposes of APRA’s Level 2 supervision, the life company, RSE licensee and unregulated institution are all deconsolidated and excluded from the application of the ADI Level 2 supervision framework.

APRA’s existing prudential frameworks do not require the Board of the Level 3 Head to oversee the risks emanating from the unregulated institution. This may be a significant ‘blind spot’ for the Board and APRA where that unregulated institution engages in activities that pose a material risk to APRA-regulated institutions. If this unregulated institution was the group’s IT services provider, for example, a disruption to this institution could have a material impact on the operations on other members of the group.

APRA has identified eight initial groups that it proposes to be subject to conglomerate supervision. Given the size of these groups, a material ‘blind spot’ in any of these conglomerate groups could have significant consequences on the financial market.

Under option 2, APRA proposes to implement two out of the four proposed components of the Level 3 framework — risk management and governance. This

would be effected by applying the existing cross-industry<sup>4</sup> governance and risk management prudential standards to Level 3 groups.

The group governance requirements would require the Head of a Level 3 group to develop and maintain group-wide policies that establish consistent processes and procedures for group governance and risk management. Group governance includes fitness and propriety of key staff, business continuity management, and the outsourcing of activities deemed to pose a material risk to the group. APRA also proposes that the Level 3 Head appoint an auditor to provide independent assurance on the appropriateness and effectiveness of group-wide policies. These standards aim to ensure that, at a minimum, the governance and risk management practices of Australian financial conglomerates meet established best practice and are overseen by the group Board.

The risk management requirements would require a Level 3 Head to develop and maintain an overarching group-wide risk management framework. The framework would be required to include a risk appetite statement, a risk management strategy and a risk management function that address material risks across the group. A consistent and integrated risk management framework would assist the Board of a Level 3 group in maintaining oversight of the material risks to the group, reducing the potential for ‘blind spots’ from which material risks can emanate undetected.

APRA does not propose to apply prudential standards to non-APRA-regulated institutions; these institutions are not proposed to become APRA-regulated. The Head of the group (an APRA-regulated institution) would be required to apply its policies to activities and persons that are considered, by the Head of the group, as posing a material risk to APRA-regulated institutions in the group. The Head of a group has the flexibility to modify these policies for particular functions or subsidiaries, provided it is aware of and can justify these differences. Essentially, under the Level 3 framework, the Head of the group must be able to demonstrate to APRA that it is aware of the material risks to the group and is overseeing the management of these risks. APRA may only impose regulatory adjustments (including capital requirements) or other requirements on the Head of the conglomerate and on other APRA-regulated institutions in the group, if necessary, to account for any additional risk from other group members.

### *Benefits*

The primary benefit of this option is that it would ensure that a conglomerate group’s governance and risk management practices meet industry best practice. Further, these proposals would ensure that the Board of the Head of the group is overseeing the material risks to the group, no matter where these material risks emanate. For example, a person within a group whose activities and decisions pose a material risk to the group’s APRA-regulated institutions would be assessed to the same level of fitness and propriety no matter where they operate.

Potential Level 3 groups have indicated to APRA that they already have group-wide governance and risk management policies and procedures, meaning that these aspects

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<sup>4</sup> ‘Cross-industry’ refers to ADIs and insurers

of the Level 3 framework largely codify existing practice. Where this is the case, the quantitative benefits of this option are expected to be negligible.

For conglomerates that do not have appropriate group-wide policies, the benefit of this option would be to ensure groups enjoy better governance and risk management, both at the management and Board levels. This means that unexpected losses to shareholders and other stakeholders will be reduced so the failure rate of APRA-regulated institutions will fall over time. This improvement in industry risk management and governance across Australian financial conglomerates means that systemic risk would be likely to fall, because there would be an accepted collective approach to good practices.

### *Costs*

Under this option, the Level 3 framework would be limited to the two components that would impose negligible compliance costs on conglomerate groups: group governance and risk management requirements. Further, this option would not impose costs associated with Level 3 groups having appropriate systems and controls to manage internal and external risk exposures.

Potential Level 3 groups have informed APRA that they already largely meet the proposed group requirements. For example, they already have a group Chief Risk Officer and separate Board Audit and Risk Committees. Given this, APRA assumes that there are negligible costs associated with implementing group-wide behavioural policies.

However, this option would leave in place potential vulnerabilities relating to the adequate capitalisation of a conglomerate group's non-APRA-regulated operations, and to potential capital upgrading or double gearing within the group. It would leave market imbalances that exist from undercapitalisation of non-APRA-regulated group members. Option 2 would also not require a conglomerate group to adequately identify, monitor and manage its aggregate risk exposures and ITEs. APRA would continue to monitor these potential aggregate risks through *ad hoc* supervisory arrangements, which are comparatively inefficient and could leave material risks unaddressed.

### **Option 3 — full implementation of a Level 3 framework**

Under this option, APRA would implement all four components of the Level 3 framework — risk management, governance, risk exposures and capital adequacy. Given that the costs and benefits of group risk management and governance are discussed in option 2, this section focuses on the costs and benefits of managing risk exposures and capital adequacy.

Under this proposal, APRA would require Level 3 groups to develop and maintain risk exposure policies to ensure that a concentration of risk in one part of, or across, a Level 3 group must not pose a threat to the APRA-regulated institutions in the group. In order to adequately manage this risk, Level 3 groups would be required to have systems and processes in place to monitor aggregate risk exposures across the group as well as intra-group transactions and exposures. The governance, data capabilities, and risk reporting would be required to be meaningful and support decision making.

The capital adequacy requirements would require a Level 3 group to have sufficient capital such that the ability of its APRA-regulated institutions to meet their obligations to depositors, policyholders and/or superannuation members is not adversely impacted by risks emanating from non-APRA-regulated institutions of the group. To ensure the level of capital held by a conglomerate group is adequate, APRA proposes two requirements:

- a Level 3 group would be required at all times have eligible capital (Level 3 EC) in excess of its Prudential Capital Requirement (Level 3 PCR<sup>5</sup>); and
- where a non-APRA-regulated institution is undercapitalised, the Level 3 group would be required to be able to cover this shortfall in a timely manner, including in stressed conditions (capital shortfall assessment).

The Level 3 PCR is proposed to reflect all material risks to depositors, policyholders and/or superannuation members of the Level 3 group. Where non-APRA-regulated activities do not expose these beneficiaries to material risk, these activities would not be included in the Level 3 PCR.<sup>6</sup> The group therefore need only have sufficient loss absorbing capital to protect depositors, policyholders and superannuation members against the risks from non-APRA-regulated activities of a group; any risks from non-APRA-regulated subsidiaries that do not lead to material risks to these beneficiaries — even if those risks are material to the standalone non-APRA-regulated subsidiary — would be excluded from the Level 3 PCR.

APRA proposes that its existing Level 1 and Level 2 regulatory frameworks would remain in place, requiring APRA-regulated institutions in a group to be adequately capitalised at a standalone and single industry level. However, APRA would not require non-APRA-regulated institutions to hold locally any capital needed to cover their contribution to the Level 3 PCR. (The ‘Problem’ section above explains why non-APRA-regulated institutions in a group can be undercapitalised, and the risks associated with this reduced ability to absorb losses.) APRA proposes instead that a group be able to demonstrate that capital can be transferred to undercapitalised non-APRA-regulated institutions to absorb losses as and when the need arises. For example, where a non-APRA-regulated institution contributes \$100 to the Level 3 PCR and only holds Level 3 EC worth \$50, the group would need to demonstrate that there is an additional \$50 somewhere in the rest of the group that can be transferred, without hindrance, to that institution if the need arises. The second requirement acknowledges that the amount of transferable capital needed depends on the degree that non-APRA-regulated institutions are undercapitalised, and the availability of that transferable capital may change under stressed conditions.

APRA considers a group that meets these two requirements to have adequate capital to protect depositors, policyholders and superannuation members from the material

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<sup>5</sup> The ‘Level 3 PCR’ is based on the minimum capital requirements applicable to the APRA-regulated group members. Intra-group exposures are netted out (i.e. lead to a reduction in the Level 3 PCR) and additional minimum capital is added for non-APRA-regulated activities that expose depositors, policyholders and superannuation members to material risk.

<sup>6</sup> Refer to the May 2013 APRA Response Paper for more technical information on the capital adequacy component of option 3: [http://www.apra.gov.au/CrossIndustry/Consultations/Documents/Level-3-Response-Paper-\(May-2013\).pdf](http://www.apra.gov.au/CrossIndustry/Consultations/Documents/Level-3-Response-Paper-(May-2013).pdf)

risks posed by non-APRA-regulated institutions in the group. The capital adequacy component would be monitored via a quarterly submission of two new reporting forms to APRA (yet to be developed).

APRA proposes that Level 3 capital adequacy (Level 3 EC and Level 3 PCR) be based on a Common Equity Tier 1 (CET1) capital approach. APRA considers that CET1 is the most appropriate form of capital as it:

- is broadly consistent with the basis on which market judgements of capital adequacy of most financial services institutions and groups are made;
- is easily identifiable across both APRA-regulated and non-APRA-regulated institutions;
- minimises unnecessary complexity in the calculation of capital at Level 3; and
- is the highest quality and most fungible form of capital available to the group, which is particularly important for managing risks during times of financial stress.

Key elements of CET1 capital include, but are not limited to, paid-up ordinary shares issued by the Level 3 Head, retained earnings, and undistributed current year earnings based on the group's consolidated accounts. The rationale for using the group's consolidated accounts is to understand the capitalisation of the group, reducing the risk that capital upgrading or double gearing from intra-group transactions will occur undetected.

APRA proposes that the Level 3 PCR be determined by aggregating the required capital for six 'industry blocks' consisting of four APRA-regulated blocks and two non-APRA-regulated blocks, plus a Level 3 supervisory adjustment, if necessary. These six blocks are:

- ADI block — the ADI Level 2 group, or, if there is no Level 2 group, the ADI and equivalent overseas deposit-taking institutions;
- GI block — the general insurance Level 2 group, or, if there is no Level 2 group, the general insurers and equivalent overseas general insurers;
- LI block — the life companies (including friendly societies) and equivalent overseas institutions engaged in life insurance business;
- Super block — the RSE licensees;
- Funds management (FM) block — all institutions conducting funds management activities not captured in the ADI, LI or Super blocks (including the non-superannuation funds management activities of dual regulated entities); and
- OA block — all other Level 3 institutions.

APRA proposes to use the CET1 requirements under its current Level 1 and Level 2 frameworks as the basis for determining the APRA-regulated blocks' contributions to the Level 3 PCR. For the FM and OA blocks, APRA proposes that groups develop internal capital models that determine the level of risk posed by their non-APRA-regulated activities. These models could be based on groups' existing internal economic capital models.

Under option 3, the Level 3 framework would replace the relevant *ad hoc* supervisory arrangements currently in place for conglomerate groups.

### *Benefits*

Capital adequacy requirements for Level 3 groups would reduce the risk of failure of APRA-regulated institutions within such groups by enhancing capital adequacy across the group, which would improve their ability to absorb losses. Sufficient capital would be held against the contagion risks emanating from the non-APRA-regulated institutions of the groups. This outcome may materially benefit depositors, policyholders and superannuation members. Given the size of the proposed conglomerates, reducing their risk of failure also improves Australian financial system stability, to the benefit of all Australians.

A key incentive of the Level 3 framework would be for groups to demonstrate a reduction in the potential for contagion between regulated and unregulated members of the group. Where a group has taken steps to lower the risk of contagion, APRA proposes to allow a reduction in the required capital for the activities of unregulated institutions. The Level 3 framework outlines a number of indicators for groups to demonstrate separability, including: the minimisation of structural, legal, branding, managerial, and asset and liability interconnectedness within the group.

A benefit of appropriate risk data capabilities is to significantly assist in understanding how contagion can spread throughout the group via intra-group transactions and exposures. The proposed requirements under option 3 would require groups to identify intra-group equity investments, loan or funding arrangements, reinsurance arrangements, guarantees or indemnities, and operational risks from the provision of intra-group services. Being able to identify the nature and size of exposure would facilitate analysis of how an issue with one institution in the group can impact other institutions, particularly APRA-regulated institutions. This would be a significant enhancement to the risk management capabilities of conglomerate groups and would allow groups to establish controls to mitigate the financial and operational impact of contagion in the group.

According to a 2011 Institute of International Finance<sup>7</sup> report, identified benefits of aggregate risk exposure monitoring and reporting include: flexibility and readiness for future volatility, avoidance of catastrophic losses, reduced expected losses/loan reserves and efficiency improvements. Further, the BCBS identified that improving the ability to aggregate risk exposures and identify concentrations quickly and accurately will improve resolvability of institutions.<sup>8</sup> While no quantification of

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<sup>7</sup> *Risk IT and Operations: Strengthening capabilities*, June 2011.

<sup>8</sup> <http://www.bis.org/publ/bcbs239.pdf>

benefits was provided, institutions did expect the benefits to outweigh the costs of enhancing to best practice standards the technology used to collect, store, calculate, manage, and report risk data, together with the set of processes used to manage risk.

Another benefit of option 3 would be the implementation of a consistent supervisory framework for conglomerates, which would replace the current *ad hoc* supervisory arrangements and increase the effectiveness of APRA's supervision, streamline compliance procedures and provide certainty to conglomerate groups and financial markets.

Finally, the consolidated treatment of EC under option 3 means that financial conglomerates would be less able to create regulatory equity through artificial intra-group transactions. At this point such arrangements are rare in Australia, though they have proven a feature in some offshore financial conglomerate difficulties such as Lehman Brothers in the US.

Option 3 complies with international best practice established in the Joint Forum's 2012 Principles. This ensures that the Australian financial system remains internationally recognised as a high-quality, sophisticated and safe investment environment.

#### *Costs*

Implementation of the full Level 3 framework would lead to additional compliance costs for conglomerate groups.

A substantial proportion of compliance costs arise from the proposed risk exposures aggregation and reporting requirements. APRA expects that there would be compliance costs associated with the development and implementation of the IT infrastructure needed to identify, monitor and manage a conglomerate group's risk exposures and ITEs, and the proposed quarterly submission of two new reporting forms. No submissions were received that quantified likely compliance costs though submissions emphasised that it could take a significant amount of time to develop the appropriate systems for risk exposures and ITEs in particular.

Based on discussions with conglomerate groups, APRA assumes total start-up costs to be, on average \$9 million per group. These costs relate to project and change management, establishing IT infrastructure for reporting of group-wide risk exposures and intra-group exposures as well as developing internal capital allocations and process for the capital shortfall assessment. It was indicated to APRA that there would likely be negligible on-going compliance costs as existing staff and processes would absorb the additional work.

Half of the total cost to industry is assumed to arise from establishing IT infrastructure for risk exposure reporting. APRA expects existing IT infrastructure would be modified to meet the risk exposure requirements. Larger groups are likely to have higher costs due to the existence of a number of legacy systems while smaller groups are likely to face lower costs due to a lower number of legacy systems. Once IT infrastructure has been modified, it was indicated to APRA that there are likely to be minimal on-going costs as existing staff and processes would absorb the additional reporting and monitoring. If members of a Level 3 group change over time, APRA

does not expect this to have an additional incremental cost in relation to Level 3 risk exposure requirements. Once the initial IT infrastructure has been modified to accommodate Level 3 risk exposure reporting, the cost of updating systems to reflect changed group membership should be no different to if Level 3 risk exposure requirements were not in place.

The proposed Level 3 capital requirements would have the potential to require a conglomerate group to raise more equity. Whether this is a cost or a benefit depends upon perspective. APRA engaged with the groups in a number of quantitative impact studies. These quantitative impact studies confirmed that the candidate groups would not currently be required to raise additional capital to meet the proposed capital adequacy requirements. APRA notes that this result would not hold if an Australian conglomerate group engages in material and artificial financing transactions designed to manufacture equity in some parts of the group, but without creating equity on a consolidated basis. The proposed Level 3 conglomerate capital regime therefore would materially reduce the potential for artificial creation of regulatory equity within a conglomerate group.

There may be some costs associated with developing a group's insight with respect to the riskiness of its non-APRA-regulated operations. As groups would be expected to already measure the riskiness of various group operations these costs would be limited to enhancing internal risk modelling to meet APRA requirements. Although the capital adequacy framework includes transferability of capital requirements relating to undercapitalised non-APRA-regulated subsidiaries that pose a material risk to depositors, policyholders and superannuation members, no comments were received on the implementation costs of these requirements. Based on discussions with conglomerate groups, APRA assumes the start-up costs for capital adequacy to average \$5 million. Costs relate to developing an internal capital allocation and establishing procedures for a capital shortfall assessment, both in relation to a group's non-APRA-regulated institutions that expose depositors, policyholders and superannuation members to material risk. It was indicated to APRA that there would likely be no on-going compliance costs as existing FTE would absorb the additional work.

In relation to governance and risk management, APRA expects associated compliance costs would be negligible. The eight conglomerate groups have indicated that they already near-fully meet these requirements.

APRA assumes a total compliance cost per group of \$9 million (\$72 million in total). APRA considers that these costs are offset by material benefits. Level 3 groups would benefit from a more stable financial position. APRA and groups also face lower operational and compliance costs as the Level 3 framework would standardise and streamline the existing *ad hoc* arrangements. Stakeholders are assumed to benefit from a more stable financial system and enhanced confidence that there is oversight of risks within a group.

To give an idea of relative scale, \$72 million is approximately 0.002 per cent of the assets of the affected groups. The identified compliance costs for all eight groups of \$72 million are less than 0.25 per cent of the conglomerate groups' financial year 2015 combined profits of close to \$35 billion. These comparisons support APRA's assumption of negligible impact on the groups' profitability and competitiveness. This



should also mean that interest rates offered to or received by customers should not be affected. As the conglomerate groups would not be required to raise additional capital to meet the proposed capital adequacy requirements, APRA does not expect the proposals to affect the ability of groups to maintain or access capital.

There is a risk that groups may restructure to avoid the conglomerate designation. The framework intends to address the risks associated with conglomerate groups, and redress the competitive imbalances from the commercial operations of such groups. APRA considers that this can be achieved either by subjecting a group to conglomerate supervision or through the group restructuring in a manner that removes the relevant risks. Through its supervision APRA would, however, address any supervisory concerns if a group were to restructure in such a manner that it was formally no longer a conglomerate group yet still materially exposed depositors, policyholders and superannuation members to the risks associated with being a conglomerate group.

APRA considers that the transition costs faced by conglomerate groups are well justified. The failure of these groups could significantly impact Australia's financial market. A failure could give rise to broader economic issues through contagion and undermine confidence in other financial conglomerate and the financial markets as a whole. The global financial crisis demonstrated that where a large conglomerate group fails, investors and other stakeholders may withdraw support (assets and funding) for other sectors of the economy, resulting in significant market and economic disruption.

Table 1 sets out the average annual regulatory costs. These relate to option 3, as the compliance costs of options 1 and 2 are assumed to be negligible. No submission from industry estimated costs via the Business Cost Calculator (BCC) or the Commonwealth Regulatory Burden Measures, although some conglomerate groups have provided APRA with high-level estimates of the regulatory impact of the proposals. The quantitative and other *ad hoc* impact assessments submitted to APRA over the years have assisted in refining the proposals to those under option 3 and contributed to the costings outlined in Table 1.

## **Consultation<sup>9</sup>**

APRA has most recently consulted on option 3. APRA first consulted on conglomerate supervision arrangements in 1999<sup>10</sup>, but elected not to proceed at that point given other priorities. The global financial crisis clarified the need for appropriate conglomerate supervision, leading APRA to resume its development of a conglomerate supervision framework.

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<sup>9</sup> All consultation documents and letters mentioned in this section can be located on APRA's website at <http://www.apra.gov.au/CrossIndustry/Pages/Supervision-of-conglomerate-groups-L3-March-2016.aspx>.

<sup>10</sup> <http://www.apra.gov.au/adi/Documents/Prudential-Supervision-of-Conglomerates-March-1999.pdf> and <http://www.apra.gov.au/adi/Documents/Prudential-Supervision-of-Conglomerates-November-1999.pdf>

APRA released a discussion paper, *Supervision of conglomerate groups*<sup>11</sup>, in March 2010, detailing its intent to develop a Level 3 framework for the regulation and supervision of conglomerate groups. APRA engaged with potential Level 3 groups in that same year and requested these groups to complete a quantitative impact assessment, which was provided by February 2011.

Letters released in May 2011 and May 2012 updated the potential Level 3 groups of the amended project timeframes and announced a data request for an updated impact assessment based on refined proposals.

In December 2012 APRA released a first response paper, *Supervision of conglomerate groups. 1. Group governance and risk exposures*<sup>12</sup>, providing a response to submissions on the group governance and the risk exposures components of the proposed Level 3 framework. It was accompanied by draft prudential standards relating to these components.

In May 2013 APRA released a second response paper, *Supervision of conglomerate groups. 2. Risk management and capital adequacy*<sup>13</sup>, providing a response to submissions on the risk management and capital adequacy components of the proposed Level 3 framework. It was accompanied by draft prudential standards relating to these components.

An August 2013 letter to potential Level 3 groups proposed an implementation date of 1 January 2015.

In September 2013 APRA released a discussion paper, *Supervision of conglomerate groups. Proposed Level 3 reporting requirements*.<sup>14</sup> It was accompanied by two draft reporting standards, and associated reporting forms and instructions relating to the capital adequacy component of the Level 3 framework.

In August 2014, APRA released proposed final prudential standards that would have implemented Option 3,<sup>15</sup> but deferred implementation due to the government's Financial System Inquiry (FSI).

Following the release of the Government's response to the FSI recommendations, APRA released a letter in March 2016 to potential Level 3 Heads outlining APRA's decision to implement the risk management, governance, aggregate risk exposures and intra-group transactions and exposures prudential requirements, but defer the commencement of Level 3 capital requirements. APRA also released for consultation

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<sup>11</sup> <http://www.apra.gov.au/CrossIndustry/Documents/Discussion-paper-Supervision-of-conglomerate-groups-March-2010.pdf>

<sup>12</sup> [http://www.apra.gov.au/CrossIndustry/Consultations/Documents/Level-3-Response-paper-1-governance-risk-exposures-\(December-2012\).pdf](http://www.apra.gov.au/CrossIndustry/Consultations/Documents/Level-3-Response-paper-1-governance-risk-exposures-(December-2012).pdf)

<sup>13</sup> [http://www.apra.gov.au/CrossIndustry/Consultations/Documents/Level-3-Response-Paper-\(May-2013\).pdf](http://www.apra.gov.au/CrossIndustry/Consultations/Documents/Level-3-Response-Paper-(May-2013).pdf)

<sup>14</sup> [http://www.apra.gov.au/CrossIndustry/Documents/Level-3-Discussion-Paper-Proposed-Level-3-Reporting-Requirements-\(Sept-2013\).pdf](http://www.apra.gov.au/CrossIndustry/Documents/Level-3-Discussion-Paper-Proposed-Level-3-Reporting-Requirements-(Sept-2013).pdf)

<sup>15</sup> [http://www.apra.gov.au/CrossIndustry/Pages/Supervision-of-conglomerate-groups-\(Level-3\)-August-2014.aspx](http://www.apra.gov.au/CrossIndustry/Pages/Supervision-of-conglomerate-groups-(Level-3)-August-2014.aspx)

revised draft prudential standards and PPG that clarified aspects of these non-capital prudential requirements.<sup>16</sup>

In addition to the above formal consultations, and noting that there are only eight proposed conglomerate groups, APRA staff have also conducted considerable informal consultation with the affected groups over the past five years.

Overall, extensive industry consultation has occurred over the past 15 and particularly the past six years, materially shaping APRA's proposals into a practical and workable solution: Option 3. These proposals are principles-based and remain sufficiently flexible to reduce 'blind spots' in conglomerate groups that differ in size, business mix, and complexity.

### **Submissions received**

APRA received 18 submissions on the March 2010 discussion paper, nine submissions on the December 2012 response paper, ten submissions on the May 2013 response paper, five submissions on the September 2013 reporting discussion paper and four submissions on the March 2016 clarifications. APRA has also actively engaged potential Level 3 groups in developing the proposed framework, via individual meetings and industry workshops.

Submissions broadly supported the objectives of the Level 3 framework. The main issues raised related to the timing of implementation, given the schedule of other regulatory proposals and the investment needed to meet the proposed risk exposure requirements. Submissions further suggested technical amendments to the capital adequacy proposals and requested clarification regarding all four components.

Submissions suggested 12 months' lead time prior to implementation, which APRA has adopted, with the non-capital requirements becoming effective on 1 July 2017. APRA has indicated to industry that implementation of capital requirements would be no earlier than 2019. APRA considers that this would provide sufficient time for all conglomerate groups to comply with option 3.

Submissions noted that the prescriptive nature of the draft aggregate risk exposures proposals could lead to material compliance costs, although no quantification was provided, and requested a more principles-based approach to these requirements. Similarly, submissions argued that the draft capital shortfall assessment was too prescriptive and could require a conglomerate group to unwind its central hedging policy, leading to increased costs and higher risks to the group; again, no quantification was provided. In response, APRA has amended the relevant proposed requirements to be more principles-based. In particular, the aggregate risk exposures standard no longer prescribes the limits conglomerate groups must implement. APRA is also minded to remove its proposed prescription on limitations around what constitutes transferable capital.

Submissions argued that APRA's proposals could place non-APRA-regulated institutions that are part of a conglomerate group at a competitive disadvantage

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<sup>16</sup> <http://www.apra.gov.au/CrossIndustry/Pages/Supervision-of-conglomerate-groups-L3-March-2016.aspx>.

compared to equivalent businesses held outside a conglomerate group; no quantification was provided. APRA considers that the proposals address competitive failures rather than create them. APRA has explicitly stated that in determining the appropriate level of capitalisation for non-APRA-regulated institutions, it will consider market benchmarks and average industry ratios for the relevant commercial industries. This will assist in addressing potential undercapitalisation of conglomerate groups' commercial operations, relative to the market requirements if those operations were outside of a conglomerate group. Further, in response to submissions and respecting its statutory obligations to protect the interests of depositors, policyholders and superannuation members, APRA has amended the capital adequacy proposals to link the capital adequacy requirements directly with contagion risks to depositors, policyholders and superannuation members. Conglomerate groups that are able to credibly and effectively separate non-APRA-regulated activities can reduce contagion risk to these beneficiaries and thereby reduce capital adequacy requirements. As a practical matter, APRA observes that the groups affected by the proposals are demonstrably among the most competitive in their industries, not only against domestic but also foreign and unregulated competitors.

Submissions argued that the widening of the scope of the outsourcing, business continuity management and governance standards could add to compliance costs (no quantification was provided). However, groups also acknowledged that they already largely meet the proposed requirements through existing group-wide policies. In relation to these standards, APRA has clarified that they only apply in relation to non-APRA-regulated institutions to the extent that such activities are material to the conglomerate group as a whole.

Technical amendments would be incorporated where necessary to improve the Level 3 framework proposals, and APRA would also provide draft guidance to clarify its expectations.

## **Conclusion and recommended option**

The groups subject to APRA's Level 3 framework collectively control a substantial majority of Australian prudentially regulated assets, and their continued health is necessary for industry and financial system soundness.

APRA proposes to adopt option 3 as it best meets the stated objective of ensuring that its supervision adequately captures the risks to which APRA-regulated institutions within a Level 3 group are exposed, and which are not adequately captured by the existing prudential arrangements at Level 1 or Level 2. Further, this option addresses the four broad components of the prudent management of financial institutions: governance, risk management, risk exposures, and capital adequacy. APRA considers that option 3 provides the greatest net benefit across all proposed conglomerate groups. This proposal will address the issues identified in the 'Problem' section and reduce the risks in relation to Board and regulatory 'blind spots' in financial conglomerates.

Nevertheless, in view of a number of related regulatory developments in train that could impact the regulatory capital framework, APRA is of the view that a pragmatic implementation approach should be adopted. In particular, APRA intends to stagger the implementation of the Level 3 framework, by deferring the capital components of

the framework. This is intended to be a pragmatic course of action that balances APRA's commitment to the Level 3 framework and the risk of undue burden on entities by implementing the capital components of the Level 3 framework that may need to be modified in the near term, depending on the outcome of related regulatory developments, including:

- the FSI recommendation on Australian ADIs having 'unquestionably strong' capital levels and any further APRA actions APRA may take in this regard in response to this recommendation;
- the FSI recommendation on implementing a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice that will facilitate an orderly resolution of Australian entities and minimise taxpayer support; and
- proposed legislative changes several wide-ranging BCBS regulatory developments in train to be finalised around the end of 2016, with the greatest regulatory capital impact expected to be on the advanced modelling banks that are also identified as Level 3 conglomerate groups; and
- the forthcoming *Crisis and Other Measures Bill* that will enhance APRA's crisis management powers and will strengthen APRA's resolution framework.

## **Implementation and review**

APRA proposes to apply the Level 3 framework by determining an institution to be an APRA-regulated institution that is the Head of a Level 3 group, which consists of that institution and its subsidiaries. APRA may adjust the Level 3 group to include or exclude entities where the accounting structure does not appropriately take into account the risks of related parties. APRA proposes to require the Level 3 Head to ensure that material risks in the Level 3 group are subject to appropriate oversight and management, according to group-wide standards and policies. APRA will assess how Boards and management address material risks in a group given these risks, unchecked, may undermine APRA-regulated institutions in these groups.

The prudential obligations required of the Level 3 Head and the Level 3 group will be implemented through amendments to APRA's prudential framework. Existing regulations on Level 1 and Level 2 institutions in a Level 3 group remain in effect and are not replaced by the Level 3 framework. Level 3 group governance and risk management requirements mirror Level 1 and Level 2 requirements, though with an extension to materially risky non-APRA-regulated activities. Capital adequacy requirements are based on existing Level 1 and Level 2 requirements, with some additional requirements for materially risky non-APRA-regulated activities. Current *ad hoc* supervision of non-APRA-regulated activities will be replaced by the standardised Level 3 framework.

As indicated above, APRA is staggering its implementation of the Level 3 framework. The risk management and governance components will commence from 1 July 2017 but, as advised to industry in March 2016, the capital elements will be deferred to at least 2019.

As with all prudential standards, APRA frequently reviews its prudential requirements to ensure they continue to reflect good practice, remaining relevant and effective.

## **Regulatory offsets**

Using the regulatory burden measurement framework, it has been estimated that the measure will increase compliance costs by \$7.2 million (refer to Table 1). For all reporting periods, the Treasury portfolio has reported net compliance cost reductions and there is no reason why the portfolio will not continue to deliver on its red tape reduction targets this year, in line with the Government’s regulatory reform agenda.

Table 1: Regulatory burden estimate (RBE) table

<b>Average annual regulatory costs (from business as usual)</b>				
<b>Change in costs (\$ million)</b>	<b>Business</b>	<b>Community organisations</b>	<b>Individuals</b>	<b>Total change in costs</b>
	\$7.2			\$7.2